IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. .....

COMMERCIAL DISCOUNT COMPANY,

Petitioner,

vs.

ETHEL STRICKLAND ROGAN, Executrix of the Last Will and Testament of Nat Rogan, Deceased,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.
SUMMARY OF ARGUMENT.

A. Congress has authorized two methods for the treatment of bad debt deductions: (1) ascertainment and charge-off, and (2) the reserve method. The two methods are inherently and basically different.

B. The rationale of the decision below destroys all distinction between the two methods of treating bad debts which Congress has authorized.

C. Neither the statutes, the regulations nor administrative practice requires of a taxpayer on the reserve method that there be any "ascertainment," "charge-off," or book entries during the taxable year.

D. The petitioner does not seek an enlargement or addition to reserve in light of subsequent events; rather it seeks to apply the general principle that net income should be computed and taxes paid on an annual basis.

E. Congress did not intend that a taxpayer should be denied the right to deduct items otherwise deductible because of mere inadvertence or ignorance of the law.

II.
ARGUMENT.

A. Congress Has Authorized Two Methods for the Treatment of Bad Debt Deductions: (1) Ascertainment and Charge-off and (2) the Reserve Method. The Two Methods Are Inherently and Basically Different.

Section 23 of the Revenue Act of 1934 provides that:

"In computing net income there shall be allowed as deductions: * * *

"(k) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to the reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

The charge-off method deals exclusively with specific bad debt items, and inherent in the process of use of such method is ascertainment of worthlessness and charge-off of specific bad debts. Such ascertainment and charge-off are expressly required of taxpayers using such method, both by the statute and regulations.[6] In the reserve method, the reserve operates as a valuation account and is an offset against the *total balance* in the accounts receivable, rather than against specific receivables.

The use of the reserve method deals with both realized and reasonably *anticipated* losses from bad debts. Inherent in this method, in contrast to the charge-off method, is the fact that a reasonable deduction may be made for losses which have not yet occurred, and so far as particular items are concerned, may never occur.

In authorizing the use of this method Congress provided, again in contrast to the deduction of specific bad debts, that reasonable additions to the reserve should be deductible from gross income.

Accounting and procedural steps authorized in the two methods are inherently and necessarily opposite and antagonistic, and regulations referring to one may not, with reason, be considered as referring to or controlling the other.

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[6]Since passage of the Revenue Act of 1942 the deduction, on this method, depends only upon the *fact* of worthlessness of specific bad debts. See Internal Revenue Code, Sec. 23(k), as amended.

B. The Rationale of the Decision Below Destroys All Distinction Between the Two Methods of Treating Bad Debts Which Congress Has Authorized.

In its opinion the Circuit Court of Appeals emphasized the controlling effect of administrative regulations [R. 137, footnote 3]. It then stated the principle, based on Art. 23(k)-5 of the Regulations 86,[7] which it held applicable to the instant case, as follows:

> "Finally they provide that a taxpayer who has established the reserve method of treating bad debts and maintained proper reserve accounts therefor may deduct from gross income a reasonable addition to such reserve in lieu of a deduction for specific bad debt items, only to the extent of the amount of 'the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.'"

That such a principle would amount to a repeal of that portion of Sec. 23(k) which authorizes the reserve method is easily demonstrated.

The existence of two alternative methods of computing a deduction from gross income on account of bad debts necessarily implies some difference or possible difference in the amount deductible from gross income in a particular year by a particular taxpayer; otherwise the existence of two methods is meaningless. For a practical example we need look no further than the facts of the instant case. The testimony shows that petitioner's actual bad debts during the year (exclusive of loss of $124,513.94 here in controversy) amounted to $39,589.28, yet the addition

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[7]See Appendix, page 31.

to bad debt reserve claimed by petitioner on its return and allowed by the Commissioner was $49,494.55 [R. 61, 81].

A striking example of the same kind is found in *Athol Manufacturing Company v. Commissioner,* 22 B. T. A. 105 (1931), where the actual bad debts for 1923 were only $52.30, yet the sum of $3,338.75 (1% of sales) was deducted by the taxpayer and allowed by the Commissioner.

The inevitable conclusion is that the Court below failed to grasp the significance of the existence of two different methods of computing the bad debt allowance, and thereby inadvertently fell into the error of repealing judicially the Congressional enactment which sanctions a method alternative to and very different from the charge-off method.

The Court's reliance was placed upon the last sentence of Art 23(k)-5 of the Treasury Regulations. A reading of this sentence is as illuminating as pages of argument on the point could possibly be. The sentence simply cannot be read to state or imply what the Court below apparently believed it to mean. The Treasury Department has never attempted, either by formal regulation or by administrative practice, to posit that the amount of deduction properly allowable to a taxpayer using the reserve method is the same as the deduction which would be allowable to the same taxpayer if he were using the charge-off method.

C. Neither the Statutes, the Regulations Nor Administrative Practice Requires of a Taxpayer on the Reserve Method That There Be Any "Ascertainment," "Charge-off," or Book Entries During the Taxable Year.

Section 23(k) above quoted is the sole statutory provision governing the right of taxpayers to take deductions because of bad debts. Analysis of this section readily reveals that the only language therein referring to the reserve method is that contained in the introductory phrase and the phrase within the parenthesis. The provisions of said section can be clearly demonstrated as follows:

> "In computing net income there shall be allowed as deductions: * * *
>
> "(1) Debt ascertained to be worthless and charged off within the taxable year; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction; or
>
> "(2) In the discretion of the Commissioner, a reasonable addition to a reserve for bad debts."

All reference in such section to ascertain and charge-off is inescapably tied to specific bad debt deductions as contrasted with the deduction of a reasonable addition to reserve. Because of the basic and inherent differences in the two methods, language referring to specific bad debts cannot be applied to the reserve method. Such a construction would necessarily render the section ambiguous and uncertain, would rewrite the law, and would destroy the right of taxpayers to use the reserve method.

Treasury regulations must also be read after eliminating from consideration the provisions thereof referring to specific bad debts, ascertainment and charge-off, since such terms by their nature are foreign to the reserve method. Once such inapplicable provisions are eliminated, Article 23(k)-1 of Regulations 86 provides for the treatment of bad debts "by a deduction from income of an addition to reserve for bad debts."

The remaining regulatory provisions relating to the reserve method (to the extent material here) are found in Article 23(k)-5 of Regulations 86.

It is respectfully submitted that language cannot be found in the Regulations requiring ascertainment and charge-off or book entries as a prerequisite to the right to deduct from income additions to the bad debt reserve. It is clear that the Treasury, in adopting Art. 23(k)-5, recognized the inherent difference in nature of the two methods. It further appears from the language of the second paragraph of that Article, wherein it is stated that the taxpayer using the reserve method "should" make a statement in his return showing volume of sales, accounts receivable, etc., that the Treasury was merely seeking statistics to enable it to ascertain the reasonableness of the addition to the reserve. Nothing more can possibly be constructed out of such language.

It is not reasonable to assume that the Treasury would choose such loose and indirect language to require ascertainment and charge-off or book entries as a condition precedent to the deduction, where it could easily have used explicit mandatory language.

The Treasury's failure by formal regulation to require either ascertainment, charge-off or book entries as a con-

dition precedent to the right to deduct from income a proper addition to the reserve for bad debts is paralleled by administrative practice. The Commissioner of Internal Revenue's practical interpretation that ascertainment, charge-off and book entries are not a prerequisite to such right to deduct, is disclosed by the record in this case, particularly by the testimony of the Government's witness, Mr. W. H. Bladon. Mr. Bladon, Internal Revenue Agent and Certified Public Accountant, was presented by the Government to the trial court as qualified to speak on the subject of the Commissioner's practice in his review of the returns of taxpayers using the reserve method and the manner in which the Commissioner exercises his discretion in allowing, disallowing or increasing additions to the reserve for bad debts.

Mr. Bladon's testimony is found in the record [pp. 96-103, inclusive]. We quote therefrom only the following:

> "Q. By Mr. O'Connor: You speak about a change in the reserve. What do you mean; an addition to the reserve or a decrease in the amount of the addition?
>
> A. *It may be either. A change may be either a decrease or an increase.*" (Emphasis added.)
>
> "Q. What determines the factor as to whether you think the additions to the reserve have been too much or whether you think the additions to the reserve have not been enough?
>
> A. Well, that is a condition of the reserve at the end of the year. In other words, you have certain

accounts and notes on the books, and you attempt to evaluate those notes and accounts by this reserve. In other words, you estimate there will be so many bad accounts in the account and notes at the end of the year. Then your reserve should equal the amount of the estimated loss.

Q. Are you guided by—

The Court: Just a moment. Listen to this answer very carefully and see if that is exactly what you meant to say. I want to be sure. Will you read it to him, please?

(The record was read.)

The Court: Is that correct?

The Witness: That is correct.

Q. By Mr. O'Connor: Then, Mr. Bladon, when the additions to the reserve are—the amount in the addition to the reserve is too much for a particular year then what action does the Commissioner of Internal Revenue take?

A. Well, he disallows the amount which he thinks is excessive and restores it to income.

Q. *Then when the amount of additions to the reserve are not enough for that particular year, does the Commissioner take the same action?"* (Emphasis added.)

"A. *Well, he will increase the reserve."* (Emphasis added.)

* * * * * * * *

"The Witness: In effect, yes. He doesn't instruct the taxpayer to make any entries on his books, but—

The Court: He instructs him for tax purposes that that would be the position of the Commissioner?

The Witness: That is correct, yes.

* * * * * * * *

The Court: *That visit to the taxpayer by the revenue agent might be six months or several years after the return is actually filed?"* (Emphasis added.)

"The Witness: *That is correct."* (Emphasis added.)

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"The Court: Just one other thing. *Regardless of the final outcome,* whether the tax is actually paid and the matter taken into the tax court or otherwise, *the taxpayer may or may not reflect on its books at that time the situation as indicated by the Commissioner?"* (Emphasis added.)

"The Witness: *That is right."* (Emphasis added.)

We submit that it is clear from the above that the Commissioner exercises the right to increase or decrease additions to the reserve after the close of the taxpayer's year. We submit further that the Commissioner assumes and exercises such right in the absence of book entries. Unless it can be said that the Commissioner is governed by a law different from that governing a taxpayer, it would follow that ascertainment and charge-off or book entries are not a prerequisite to the right of a taxpayer on the reserve method to secure the deduction.

D. The Petitioner Does Not Seek an Enlargement or Addition to Reserve in Light of Subsequent Events; Rather It Seeks to Apply the General Principle That Net Income Should be Computed and Taxes Paid on an Annual Basis.

It is admitted by both the petitioner and the Government that the debt in question is related solely to the taxable year 1934, and that unless petitioner's position here is sound such loss can in no way be reflected for income tax purposes.

All the facts upon which the questioned debt depended were completely ascertained within the taxable year. All the facts that could ever occur with respect to the loss occurred in the taxable year. *The debt was extinguished during such year* [R. 122]. The transaction was closed during such year.

The taxpayer, through ignorance of the law controlling the tax incidence of such transaction, failed to ascertain and reflect on its books the *amount* of its loss. Because of such oversight or neglect, this case is at issue.

The quotation [R. 142] of the court below from *Farmville Oil & Fertilizer Co. v. Commissioner*, 78 F. (2d) 83 (C. C. A. 4) is not, we submit, controlling under the facts of this case. The taxpayer there was attempting to enlarge its reserve "in light of subsequent events" and so to permit would result, under the facts there, in a deduction "in a year prior to that in which their (the debts') worthlessness would be realized."

The decision in *Consolidated Dry Goods Co. v. United States*, 35 F. Supp. 523 [R. 142], is, we submit, likewise not contrary to petitioner's position here. There the taxpayer's estimate of the reasonable addition to reserve was

"fairly made" *in light of all losses anticipated or actually occurring in such year,* and in the following year it attempted to *revise* such estimate for the sole and obvious purpose of throwing the addition, and thus the deduction from income, into the most advantageous year.

In the case at bar, all the facts and events upon which the worthlessness of the debt and amount of the loss depended occurred in the taxable year. To grant that which petitioner here seeks would not permit a deduction on account of the bad debt in a year prior to that in which the worthlessness was realized or occurred. Here evidence was submitted as to what would have been a reasonable and proper addition to the bad debt reserve for 1934, in the light of the circumstances existing at the end of that year [R. 70]. That the proper amount of the addition to bad debt reserve in any case is a question of fact is obvious. The facts that are deemed pertinent in the present case were presented by petitioner's witness J. D. Savant [R. 61-62, 66], were restated by the trial court [R. 68] and confirmed by government witness H. W. Bladon [R. 97-98]. The latter agreed that one of these pertinent facts is the amount of bad debts actually incurred during the taxable year [R. 101].

Based on this evidence (there being no conflict between petitioner's witness and the government's witness) the trial court found that the sum of $174,109.38 was, as claimed by petitioner, a reasonable addition to petitioner's reserve for bad debts which should have been made for the year 1934 [R. 41]. The government's statement of

points to be relied upon on appeal does not include any attack on this finding [R. 126-128]. It follows that there can be no complaint that the petitioner's case here is rested upon hindsight or upon factual developments which had not occurred or were not reasonably anticipated during the year 1934.

E. Congress Did Not Intend That a Taxpayer Should Be Denied the Right to Deduct Items Otherwise Deductible Because of Mere Inadvertence or Ignorance of the Law.

With a single exception, which will be discussed below, the revenue laws completely fail to require, either expressly or by implication, that a deduction which is allowable under the law must appear on the books or in the tax return in order to entitle the taxpayer to a refund on account thereof. The only questions in an action on a rejected refund claim are whether there was an overpayment of the tax and whether the taxpayer took the requisite procedural steps within the respective periods of time allotted therefor.

On the taxpayer's books for the year 1934, and in the taxpayer's income tax return for that year, the taxpayer failed to claim a deduction of the sum of $124,513.94 which the taxpayer would have included in its addition to reserve for bad debts had it not misunderstood the law to be that the particular transaction constituted a purchase of the property for a consideration equal to the amount of the debt. It was the taxpayer's understanding that no matter what the value of the property was at the time it was acquired in 1934 the taxpayer was not entitled to claim any loss until it had sold the property [R.

71]. As late as 1941 the view of the Commissioner of Internal Revenue as to the law was also erroneous.[8]

Having made this error, the taxpayer sought to correct its income tax return by filing, in 1938, a claim for refund based on the deduction which it would have set up on its books and claimed in its tax return had it correctly understood the law [R. 6, 41, 70-71].

The principle is thoroughly established that where a taxpayer has failed to set up a deduction on its books during a particular year and has failed to claim that deduction on its income tax return for that year, it is, nevertheless, entitled to a refund if it files a claim therefor at any time within three years after the return was filed. Numerous cases have allowed deductions by way of refund claims although such deductions had been overlooked entirely during the year in question and had not been claimed on the income tax return:

Hyatt Roller Bearing Co. v. United States, 43 F. (2d) 1008 (Ct. of Claims, 1930);

Huber v. United States, 16 F. Supp. 773 (Ct. of Claims, 1936);

Gimbel v. Rothensies, 24 F. Supp. 117 (Pa. D. C. 1938);

Monmouth Plumbing Supply Co. Inc. v. United States, 4 F. Supp. 349 (Florida D. C. 1933);

Saylor Elec. & Mfg. Co. v. United States, 33 F. Supp. 310 (Mich. D. C. 1939);

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[8]In *Commissioner v. Spreckels* (C. C. A. 9, 1941), 120 F. (2d) 517, the court ruled against the Commissioner's contention that such a transaction as was involved in this proceeding did not give rise to a bad debt.

Smith v. United States, 16 F. Supp. 393 (Mass. D. C. 1936);

Moore v. Hoey, 31 F. Supp. 478 (N. Y. D. C. 1940);

Chisolm v. United States, 19 F. Supp. 274 (Ct. of Claims, 1937);

Page v. Rhode Island Hospital Trust Co., 88 F. (2d) 192 (C. C. A. 1, 1937); (for more complete statement of facts, see *Rhode Island Hospital Trust Co. v. Page,* 14 F. Supp. 481);

Weintraub v. United States (Pa. D. C. 1939), Prentice-Hall, 1939 Fed. Tax Service, Par. 5.602.

The only exception to this general principle existed prior to 1942 with respect to losses on account of bad debts of taxpayers who were on the charge-off method. Commencing with the Revenue Act of 1913, taxpayers were permitted a deduction from gross income of "debts due to the taxpayer actually ascertained to be worthless and charged off within the year." Substantially the same language has remained in the law until the Revenue Act of 1942. However, by the Revenue Act of 1921 (Sec. 214(a)(7)), Congress wrote into the law authority, in lieu of charging off specific bad debts, to set aside and deduct additions to a reserve substantially as the right now exists in Section 23(k) of the Internal Revenue Code.

It is apparent from a cursory reading of the language contained in the Revenue Act of 1913 quoted above (and the corresponding provisions of later laws) that prior to the Revenue Act of 1921 losses on account of bad debts could be deducted in only one way; and further, that in order to obtain such deduction, the debt must "be ascer-

tained to be worthless and charged off within the taxable year."

Numerous cases could be cited showing substantial relaxations of the strict rule imposed by the statute upon taxpayers using the charge-off method. The record of such cases evidenced a growing conviction that the statute governing the charge-off method was unnecessarily harsh and stringent.

In 1942 Congress, by Section 124(a) of the Revenue Act of 1942, eliminated entirely the requirement of ascertainment and charge-off. The 1942 amendment permits deduction of "all debts which became worthless within the taxable year," and the change was made retroactive to all taxable years beginning after December 31, 1938 (Revenue Act of 1942, Sec. 124(d)).

This amendment made no change whatever in that portion of the section relating to the treatment of bad debts by a taxpayer using the reserve method. The reason, of course, is that the requirement so removed did not apply to the taxpayer using the reserve method.

It follows from the above that petitioner did not lose its right to the deduction merely because it failed to determine the amount thereof during the taxable year and claim the same at the time of filing its return. Our research has disclosed only two cases which announce principles controlling under the facts of this case.

In *Athol Manufacturing Company*, 22 B. T. A. 105 (1931), the taxpayer entered on its books an addition to

bad debts reserve in the amount of $8,434.75 for the year 1924. The Commissioner admitted that debts in the amount of $20,895.21 actually became worthless during the year. The Board of Tax Appeals held at the instance of the taxpayer that a further addition to bad debt reserve for the year 1924 should be allowed in the additional amount of $9,174.01, or a total of $17,608.76. This decision, rendered in 1931, thus more than doubled the allowance for addition to bad debt reserve for the year 1924, more than six years after the close of that taxable year. On appeal by the taxpayer (other points were also involved in the case) the decision of the Board of Tax Appeals was affirmed. (*Athol Mfg. Co. v. Commissioner,* 54 F. (2d) 230 (C. C. A. 1st, 1931).)

In *The Proctor Shop, Inc.,* 30 B. T. A. 721 (1934), the taxpayer claimed in its tax return for the taxable year ending January 31, 1929, an addition to its reserve for bad debts in the amount of $16,961.42. The Commissioner upon examining the return proposed to reduce this figure to $14,971.17. Some five years after the close of the taxable year the Board of Tax Appeals held that the amount which should properly have been added to the reserve was $21,776.24, a sum substantially greater than that originally claimed, and ruled that the taxpayer was entitled to have its tax liability reduced by reason of this additional allowance.

It is respectfully submitted that these two decisions correctly reflect the Congressional enactment, the Departmental regulations, and the actual administrative practice. The same principle is applicable to the instant case.

Conclusion.

Wherefore, it is respectfully submitted that this petition for writ of certiorari to reverse the judgment of the Circuit Court of Appeals for the Ninth Circuit should be granted.

Dated: September 21, 1945.

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